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FM AMEMBASSY TASHKENT
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INFO ALL SOUTH AND CENTRAL ASIA COLLECTIVE
EUROPEAN POLITICAL COLLECTIVE

UNCLAS SECTION 01 OF 04 TASHKENT 001567

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SUBJECT: UZBEKISTAN'S COTTON SECTOR STILL A BASTION OF THE COMMAND
ECONOMY

REF: 08TASHKENT1204; 08TASHKENT1323; 08TASHKENT1356; 1511; 1547

¶1. (SBU) SUMMARY: The Government of Uzbekistan (GOU) continues to control the "commanding heights" of the cotton sector, exercising strict control over all aspects of cotton production and sale, from setting planting and harvest quotas to negotiating all ginning and export contracts on behalf of farmers. Major cotton policy provisions in Uzbekistan are aimed at stabilizing the cotton cultivation area, improving yields, efficient use of irrigation water, and increasing domestic mill use of cotton. Although the sector is in dire need of reform to alleviate environmental problems and the traditional reliance on child labor, little has changed since Soviet times. Cotton still accounts for an important (albeit shrinking) portion of Uzbekistan's GDP. END SUMMARY.

COTTON PRODUCTION DOWN SLIGHTLY

¶2. (SBU) Uzbekistan's cotton harvest was later than usual this year after an exceptionally wet spring required replanting of crops. Total hectares of seed cotton planted in 2009 approximate 1.3 million, down by around 70,000 hectares from last year. This drop may be attributable to a presidential decree in October 2008 ordering a decrease in the cotton planting area in order to increase farmland available for food cultivation and to combat on-going irrigation issues. (See Ref B.) Nevertheless, this year's plant area amount is consistent with the GOU's aim to maintain the cotton-producing area at about 1.4 million hectares. Cotton remains the country's main agricultural export, accounting for roughly 12% of all exports and 7-8% of the country's GDP (2008 estimate). The global economic crisis has slowed the demand for Uzbek cotton, and exports are estimated to decline this year from 3.0 million bales to 2.9 million bales.

¶3. (SBU) Uzbekistan is one of the few countries clinging to a Soviet-era command economy for cotton. Uzbekistan's Ministry of Agriculture and Water Resources (MOA), in consultation with regional advisors and local farm associations, mandates the amount of seed cotton to plant throughout the country. Each fall, local associations meet collectively to estimate the next season's expected output and necessary inputs. District plans are submitted to the regional authorities, and regional plans are approved at the national level.

¶4. (SBU) This year, the Ferghana valley area accounted for more than 20% of the land under cotton cultivation (303,560 hectares), with significant portions of land also being cultivated in Kashkadarya (161,000 hectares) and Bukhara (117,948 hectares). On October 30, 2009, the GOU announced it reached its production

target of 3.4 million metric tons (MMT) of seed cotton harvested. The GOU sets its production target each spring. This number is then broken down by region, and district hokims (governors) are responsible for making sure that the delivery quota is filled, down to each individual plot's share of the overall quota. Over the last several years, it has become increasingly difficult for producers to meet state targets due to poor farming practices and the absence of appropriate production incentives. (Note: Official production reports generally match the production targets, regardless of the actual yields. In December 2008, state media declared that farmers had harvested 98% of the total state target for seed cotton -- 3.6 MMT. Independent analysts found this report unrealistic, as farmers struggled against an unusually cold winter with above-normal snow followed by an early and dry spring. End note.)

COMPULSORY STATE ORDER SYSTEM STILL THE NORM

15. (SBU) The Ministry of Finance has set the new average procurement price for seed cotton at Uzbek Soums 502,550 per ton (about USD 330), an increase of about 20% over last year's price, largely due to inflationary pressures. The GOU calculates its procurement price by subtracting official costs from export revenues. These costs include loans to farmers for inputs such as

TASHKENT 00001567 002 OF 004

fertilizers and pesticides, irrigation system maintenance (water is free for the agricultural sector), ginning and marketing costs, and financing of farmers' debt. In theory, this procurement price should be the full international price minus costs; however, the world price is calculated at an overvalued official exchange rate, and the charges for inputs, processing and marketing are typically understated. Thus, the price paid to farmers rarely results in profits, and every year Uzbek farmers cross the border to fetch higher returns in Kazakhstan.

16. (SBU) Uzbekistan has established a special fund under the Ministry of Finance for purchasing agricultural commodities for State needs. At the beginning of the cotton season, the GOU deposits funds into local commercial banks, which then issue an 80% advance payment (actually a 3% loan) to cotton farmers. The banks pay this advance to farmers in two tranches: one paid before cotton planting, a second during vegetation and watering. After all cotton has been delivered to gins and the quality assessed, the balance is settled. Farmers must repay the original loan, if able, or seek debt-write-offs or other remedies if their revenues do not exceed their expenses, including financing costs.

17. (SBU) In December of 2002, the GOU adopted a decree that allows farmers to sell up to 50% of their cotton output either domestically or abroad. This decree theoretically was supposed to bring the government's monopoly on the cotton market to an end and create production incentives. However, no concrete practical mechanisms have developed to allow this process to begin. Consequently, although officially the State order remains at 50% of the cotton produced, the State remains the only major player in cotton production and marketing.

GINNING INDUSTRY DOMINATED BY STATE

18. (SBU) The state cotton ginning association -- Khlopkopromsbyt, a joint-stock company in which the GOU holds 51% ownership, procures and gins all state-ordered and over-quota cotton. It coordinates the activities of farmers and approximately one hundred and fifty gins located throughout Uzbekistan. Financial issues between the

cotton farmers and cotton gins are handled in accordance with a model agreement prepared between the MOA and Khlopkopromsbyt and approved by the Ministry of Finance. Khlopkopromsbyt earns a two percent commission for its coordination efforts, which is deducted from the cotton lint price at the time of sale.

¶9. (SBU) Uzbek gins, on average, sell cotton lint at cost plus 10%. This 10% does not necessarily translate into revenue for the gin, however, because regional authorities may impose "social responsibility" fees on gins, such as to support a school or kindergarten located close to its territory. Uzbek cotton gins are less efficient than other cotton producers: gins have a relatively low outturn ratio (about 32%, compared to 35-36% in the U.S.), and gin fewer bales per hour on old Soviet equipment. Currently, average production costs of Uzbek cotton gins approximate USD 240-250 per ton. In comparison, Kazakh gins' average production cost is reportedly USD 120-130 per ton -- almost half of Uzbek gins' production costs. There is little incentive to increase productivity, as any increase in the average profit margin becomes a basis for a decrease in the following year's State payments.

¶10. (SBU) Three trading companies under the Ministry of Foreign Economic Relations, Investments and Trade (MFERIT) have a monopoly on contracts for exporting Uzbek cotton with Khlopkopromsbyt. Approximately 85% of Uzbek cotton is exported by these trading entities, with the remaining 15% sold through the Republican Commodity exchange or directly to domestic buyers by gins. After deducting a 2% percent commission for exporting services, the trading companies surrender hard currency receipts to the Uzbek Central Bank at the official exchange rate (an implicit tax). The difference between the national currency receipts and the domestic price is then transferred to the state budget. This year's average cotton lint price sold by cotton gins to the trading companies is Soums 1,812,000 per ton (excluding 20% VAT), or about USD 1,193. Uzbekistan expects to export around 700,000 tons of cotton lint at an average export price of approximately USD 1,460 per ton, netting

TASHKENT 00001567 003 OF 004

approximately USD 267 per ton (exclusive of commission and taxes) for the State.

¶11. (SBU) Currently, Uzpromashimpeks, one of the MFERIT trading companies, is on the Committee for International Cooperation among Cotton Associations' (CICCA) default list after Noble Cotton, a Singapore-based cotton supply chain management firm, won an arbitration judgment against Uzpromashimpeks for failing to deliver cotton according to contract terms. This judgment does not appear to have substantially impacted Uzpromashimpeks' selling position: at the recent Fifth International Uzbek Cotton Fair, which took place in Tashkent on October 14-15, 2009, several international companies made commitments with Uzpromashimpeks, including Chinatex Corporation and the newly-formed Dubai Cotton Center (DCC). (See Ref E.)

MECHANIZATION OF INDUSTRY CONTINUES TO LAG

¶12. (SBU) Currently, only 2-3% of Uzbekistan's cotton is machine-harvested, as compared to 70% machine harvested in Soviet times. Uzbekistan does not have the capacity (or any incentive) to manufacture modern cotton-picking harvesters, and the abundance of cheap labor, including child labor, makes it economically unattractive to invest heavily in machinery. The average price paid to cotton pickers in 2008 was 80 Uzbek Soums per kilo (about USD 0.05). One harvester machine will clear about 500 hectares in a season; however, each machine costs hundreds of thousands of dollars. (Note: Few countries have the capacity to manufacture the

industrial components for cotton-harvesting machines. Uzbekistan, if appropriately incentivized, could import harvester components and assemble machines domestically.) Contrary to Uzbek claims, hand-picked cotton is not necessarily of higher quality than the machine-harvested variety. While some international experts have cautioned against mechanization because of the need to use defoliants, other experts maintain that defoliants are safe for the environment and people if properly used. Recent press reports indicate that the GOU may be taking a second look at mechanization. According to Uznews.net, an online media outlet, the GOU plans to reequip four industrial enterprises that produce agriculture equipment, including cotton harvesters.

¶13. (SBU) Recent farm reorganization legislation may allow for greater mechanization of the cotton harvest. In late 2008, the GOU began the process of farm amalgamation, according to which smaller farms were merged into larger farms. The government set a minimum size of 80-100 hectares for cotton-and-grain producing farms and 15-20 hectares for vegetable and fruit farms. While modern harvest equipment is simply too expensive for small farmers, the growth of large farms could make purchase of machinery more feasible. The World Bank supports a program whereby farmers can access credit to buy farm equipment, including harvesters, while at the same time undertaking not to employ child labor.

DOMESTIC CONSUMPTION AND TRADE

¶14. (SBU) Uzbekistan is actively pursuing the goal of becoming a textile exporter. Current domestic consumption is about 25%, and outdated gins operate significantly below capacity. Since 2005, the GOU has invested significantly in developing the spinning industry, including offering tax (excluding VAT) and import duty exemptions for foreign investors. An Uzbek enterprise with direct foreign investment automatically receives a 15% discount from the world price of cotton fiber with a 120-day delay in payment. Forty-one joint ventures now exist with companies from Korea, Turkey, Germany, Japan and Switzerland. Total foreign investment in the sector was estimated at USD 1 billion at the end of 2008.

¶15. (SBU) Currently, the main products produced by textile mills are cotton yarn and gray fabrics. The industry is expanding production of value-added products, such as shirts and other garments for the export market. At the recent cotton fair, the GOU announced that domestic cotton consumption for 2009 will reach 300,000 tons, up from 250,000 tons in 2008. This increase is

TASHKENT 00001567 004 OF 004

smaller than previously predicted by the GOU, which had sought to increase the 2009 volume of domestic consumption as much as 50% through its modernization program. In addition to expanding ginning capacity, the GOU also is active in scientific research relating to cotton, including seed multiplication and other sophisticated biotechnology research.

¶16. (SBU) Uzbekistan is a primary supplier of cotton to Asia, with Bangladesh, China (Mainland), and South Korea the major markets for Uzbek cotton. Uzbekistan accounts for 60% of cotton imports by Bangladesh and for about 10% of imports by China (Mainland). Russia still remains a significant and stable buyer of Uzbek cotton, importing about 100,000 tons per year. Uzbek cotton is also transported by rail to ports in the Baltics and Turkey for sale to Europe. The bulk of Uzbek cotton, however, passes through Iran to the port of Bandar-Abbas for export to Asia. The Trans-China corridor via Kazakhstan also serves as an alternative to the Iranian route.

CHILD LABOR AND FORCED LABOR ISSUES REMAIN

¶17. (SBU) The practice of using child labor in cotton harvesting remains prevalent and dates from the Soviet era. Last year, on September 12, the Cabinet of Ministers issued a resolution on the implementation of two ILO conventions against child labor that the GOU had signed earlier in the year, and this reportedly reduced the number of children in the fields at the beginning of the harvest. The GOU has also formulated a national action plan to carry out the ILO Conventions, but implementation of this action plan is still nascent. The extent to which child labor was used in the 2009 harvest is difficult to estimate, as no independent assessment has been carried out, and there is no real baseline number with which to compare. Post continues to receive reports of some school districts mobilizing children to help meet quotas at local farms in this year's harvest.

Comment

¶18. (SBU) This year's cotton production is in line with previous years, at least officially. The cotton sector is in need of comprehensive reform from top to bottom. Although the GOU has made strides in diversification of crops, it has taken no steps to grant farmers greater control over what they plant, or to develop the necessary infrastructure that would allow farmers to sell their cotton themselves on an open market. Doing so would increase efficiency in the system, and, if farmers could pay a decent wage rate, attract unemployed adult workers (of which there are many) to work the fields, obviating the need to mobilize children during the harvest. Post will submit septel some ideas on how the USG might be able, with the UN and others, to assist with short- and longer-term measures to address the child labor issue. End comment.
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